

the 1990 access tariff filing, the Commission used statistical analysis to evaluate LEC forecasts of plant and expense and disallowed costs in various categories when growth rates of projected costs fell outside calculated ranges.

Incentive regulation eliminates the automatic tie between costs and rates that existed under cost-based, rate of return regulation. However, the Commission's oversight responsibilities under incentive regulation concentrate on ensuring that quality service is provided at prices that are just, reasonable, and non-discriminatory.

State

Likewise, state commissions have performed stringent reviews of LEC investments and expenses, during rate cases, earnings reviews and other regulatory proceedings. For example, in Oklahoma, the Commission Staff reviewed SWBT's plant and facilities and found that amounts of spare/reserve capacity were reasonable.⁶² Similarly, during the 1989 rate design investigation in Missouri, the Commission Staff reviewed the justifications and analyses used by SWBT in making switch replacements and determined that SWBT's switch deployment schedule was in the public interest. In addition, the Missouri PSC stated that factors other than economics, such as expanded service to customers, improved quality of service and attraction of new customers must be weighed in determining whether new technology should be deployed, and that these factors can outweigh the economic factors.⁶³

3. Actual Costs Were Prescribed and/or Endorsed by Commissions.

LECs have incurred substantial capital investments and expenses in order to comply with specific Commission regulations and orders.

⁶²Oklahoma Cause No. PUD 000662, Order of the Commission, p. 185 - Excess Capacity Review.

⁶³Missouri Case No. TC-89-14, Report and Order, p. 51-56.

Federal

Examples of specific regulatory requirements include:

- 1) 800 Database - Network improvements, databases and Signaling System 7 (SS7) upgrades, including the installation of Signaling Transfer Points, and implementation of SS7 interconnection sufficient to meet access time standards;
- 2) Number portability and required nondiscriminatory access to support systems;
- 3) Equal Access and Network Reconfiguration - switching hardware and software and other billing and support systems required to offer dialing parity and presubscription among interexchange carriers;
- 4) Interconnection - construction of gateways to allow access to operating support systems, and expenses incurred for 'branding.'

State

State commissions and legislators have endorsed the implementation of incremental network modernization programs which require capital expenditures for items such as the upgrade of central office switches and interoffice facilities to digital technology, upgrades to customer service by eliminating multi-party service, deployment of interoffice fiber, ISDN capabilities and broadband to schools, hospitals, libraries, and government offices, in order to provide all customers with improved service quality and access to the latest technology and new services available.

Some states have ordered these accelerated capital expenditure programs over and above those that would be made on a "business as usual" basis, citing the benefits to customers of a state-of-the-art telecommunications system. The Oklahoma Cause PUD No. 000662 order acknowledged that "due to the capital intensive nature of utility investments and the public service

nature of the business, it is not always true that investments in a utility's system will be cost-effective from an economic perspective."⁶⁴

In addition, some state commissions have required funding for the administration of other programs, including systems for the speech and hearing impaired, toll calling plans, tele-community centers, etc.

4. Operating Efficiencies in the LEC Industry

In order to provide incentives for greater efficiency, federal and state regulators have prescribed price cap or other alternative regulation plans. The Commission acknowledged that rate-of-return regulation "cannot create the positive incentives that are embodied in incentive-based regulation."⁶⁵ The Commission specifically changed its form of regulation from a cost-plus approach to incentive regulation, making that regulation mandatory for the largest carriers. In describing its decision to require incentive regulation, the Commission stated:

In designing an incentive-based system of regulation for the largest LECs, our objective, as with our price cap system for AT&T, is to harness the profit-making incentives common to all businesses to produce a set of outcomes that advances the public interest goals of just, reasonable and nondiscriminatory rates, as well as a communications system that offers innovative, high quality services.⁶⁶

* * *

Opportunities presented by incentive regulation for enhancing efficiency in the LEC industry include the opportunity to provide better incentives for innovation. Innovation is not a term we define narrowly, as several do, to mean technological breakthroughs that lead to new services or offerings. Our definition of innovation is much broader, incorporating innovation in management systems, administration, and the multitude of what economists term "inputs" that are used to produce a

⁶⁴Oklahoma Cause PUD No. 000662, Order of the Commission, p. 212-213, Comments of the Administrative Law Judge.

⁶⁵LEC Price Cap Order, ¶ 25.

⁶⁶LEC Price Cap Order, ¶ 2. See also, AT&T Price Cap Order, ¶¶ 20, 88-90.

firm's "output." In our view, innovation in how a company produces its output is one of the chief ways a company becomes more productive and efficient.⁶⁷

LECs have utilized the opportunities inherent in the incentive and alternative regulation plans to become more efficient in their operations. Because of the incentives in price cap and alternative regulation, LECs have the opportunity to retain additional earnings gained through more efficient operations. Since the late 1980s, the industry, operating within these incentive regulation plans and facing increased competition, has become increasingly more efficient. Collectively, the RBOCs have reduced the number of employees per access line by over 30% in the past five years. Cash operating expenses per access line have decreased 6% over the past five years. Over the same period, inflation has increased approximately 15%, resulting in an inflation adjusted decrease of over 18%. In summary, the price cap was a regulatory "deal" and SWBT is doing its part to become more productive and to pass those productivity gains on in the form of access price reductions. However, unbundled elements at TELRIC price levels (which substitute for access services) breaks the Commission's part of the "deal."

Additionally, network modernization programs have benefited the customers through improved telephone service and access to a greater variety of service offerings. These programs and other efficiency efforts have achieved cost savings from reduced work force and lower central office maintenance and other plant operations and network-related expenses.

The continually improving infrastructure, service quality and access to enhanced services made possible by LEC investments have not only benefited LEC customers, but society as a whole, by creating a network capable of delivering a full range of technological opportunities.

⁶⁷LEC Price Cap Order, ¶ 31.

B. TELRIC PRICES ARE INAPPROPRIATE.

The Commission proposed that as a trigger for Phase 1 treatment, unbundled network elements be available at forward-looking economic cost, *i.e.*, on the basis of TELRIC of the network element.⁶⁸ The Commission also asked whether to prescribe TSLRIC-based access rates in its prescriptive approach to access reform, in the event that the market-based approach is not considered adequate.⁶⁹ There is a common thread between all of these Commission proposals: the use of cost data to set prices or PCIs directly.

The issue here is that a cost is not a price, and even in competitive markets, costs are not usually equated with the Commission's concept of TELRIC or TSLRIC. Setting prices at TELRIC plus an allocated share of forward-looking joint and common costs may not allow a LEC to recover its actual costs. Regardless of whether one looks at costs via TSLRIC (on a service basis) or TELRIC (on an element basis, which purportedly "minimizes" common costs), there are still significant LEC costs that cannot be attributed directly to services or elements, plus significant overheads. While it is true that future decision-making depends on the actual incremental costs a firm expects to incur on a forward-looking basis (in contrast to hypothetical or proxy costs), it is also true that no firm can be reasonably expected to attract equity capital if it does not have an opportunity to recover its costs and earn a return on its investment.

The Commission seeks to emulate the access prices that would have been produced by a competitive market, but a strict reliance on cost data to meet this objective can lead to incorrect results. There are three basic reasons for this. First, markups (*i.e.*, the contribution contained in a product's price, expressed as a percent of the direct costs) in competitive markets are not

⁶⁸NPRM, ¶¶169-70.

⁶⁹NPRM, ¶219.

automatically "small," but regulatory agencies often assume this, or assume markups away altogether. However, common competitive products often reflect markups in the range of 50-300% above what the Commission calls "economic cost."⁷⁰ Second, the maxim that price equals long-run incremental cost in a competitive market is a good theoretical maxim as far as it goes, but a strict adherence to this maxim will lead pricing policy astray.⁷¹ The "price equals long-run incremental cost" rule must be modified if one intends to set prices for a large, network-based multiproduct firm. Third, prices can still differ substantially even if costs do not. This depends on the demand side of the market, something that all competitive firms must consider.⁷² A strict reliance on costs as the driver of price does not tell the whole story, and can result in prices that do not emulate a competitive market.

The point is that the Commission's single objective should *not* be to drive access prices to artificially construed TSLRIC levels. Rather, the Commission should seek solely to more efficiently structure access rates so that structurally they are not precluded from reflecting prices observed in competitive markets.

⁷⁰See, Alexander C. Larson, *A Price Is Not a Formula*, 134 PUB. UTIL. FORT. 13 (Sept. 1, 1996).

⁷¹Telecommunications companies are multiproduct firms that exhibit scale and scope economies and substantial joint and common costs; no long-run incremental cost calculation for any single product includes these costs. It is well known that if a multiproduct firm has scale and scope economies, the sum of the incremental costs of the services offered by that firm will not sum to the total costs of operating the firm. However, the above maxim assumes implicitly that the sum of the separate long-run incremental costs for all of the products of a multiproduct firm add up to all of its costs, including the joint and common costs. This assumption simply isn't valid, for substantial joint and common costs are residual to the incremental cost calculations. For this reason, substantial margins in excess of long-run incremental cost calculations are observed for separate products in the real world. This could also be true for access services priced to emulate a competitive market.

In competitive markets, prices must cover incremental costs, but also must cover: (1) the joint and common costs of all services, and (2) the opportunity cost of capital, resulting in potentially large markups in the prices of *individual services* to ensure that all costs are recovered. Markups on individual services in competitive markets are quite large because they must accommodate joint and common costs and opportunity costs; however, in applying "cost-based" pricing that is actually formula-based pricing, regulatory agencies may overlook these other costs (which are potentially large for network-based industries such as telecommunications) and assume that markups on individual services must be "small" or zero to be "reasonable."

⁷²For example, a hot pink two-story home in Montgomery County, Maryland costs the same to build as a white one, but ask any real estate broker which one would sell faster.

C. THE USE OF PROXY MODELS FOR THE COSTING OF ACCESS ELEMENTS IS INAPPROPRIATE, AND CURRENT PROXY MODELS HAVE NOT BEEN VALIDATED.

In paragraph 220 of the NPRM the Commission described AT&T's and MCI's models that they have proposed be used for unbundled network element pricing and also suggested that these same models be used as the basis for reform of interstate access prices. In paragraph 222, the Commission noted that specific comments will be requested on the use of models for estimating forward-looking costs. An FCC Staff paper was released for Comment on January 9, 1997, with Comments to be filed on February 3, 1997 and Reply Comments on February 14, 1997. SWBT intends to file its comments in response to that request but will provide a short, but not all inclusive, synopsis here.

The Hatfield Model Version 2.2, Release 2 (HM2.2.2) referenced in the NPRM has been the subject of much criticism in the universal service proceeding and elsewhere, including the recently held Joint Board Staff Workshops on Proxy Cost Models. Some of the criticisms include:

The HM2.2.2 uses census block group (CBG) for household counts and assumes that the equivalent area of the CBG translated into a square will be used to design a loop network when actual CBGs are irregular in shape. In addition the model assigns the CBG to the closest RBOC Wire Center (It only includes RBOC Data), not necessarily the wire center that serves the majority of the households in that wire center.

A number of problems with HM2.2.2 have been identified by other parties in the Universal Service Proceeding - See "Not the Real McCoy: A Compendium of Problems With The Hatfield Model," Filed by USTA as an Ex Parte in CC Docket No. 96-45 on October 16, 1996.

SBC identified a number of problems in its Comments in CC Docket No. 96-45 filed on December 19, 1996, specifically Attachment A which is a Sensitivity Analysis for SWBT in Missouri, and Attachment B, which is a similar Sensitivity Analysis for SWBT in Texas. In these analyses SWBT points out that the use of unsubstantiated structure sharing assumptions by Hatfield understate the cost of loop by as much as 30%. Also unreasonable depreciation lives and unrealistic cost of capital contribute to a significant understatement.

D. ACCESS ARBITRAGE OPPORTUNITIES ARE CREATED BY THE AVAILABILITY OF UNBUNDLED NETWORK ELEMENTS.

Unbundled network elements are functionally equivalent to the access elements they were designed to replace. From a practical standpoint, the price advantage the Commission has conferred on the purchasers of unbundled network elements represents an extreme form of unreasonable discrimination.

The NPRM is literally laced with acknowledgments that competitive alternatives through unbundled arrangements provide immense arbitrage opportunities. Paragraph 8 explains that the availability of unbundled network elements priced at forward-looking prices "jeopardizes the source of revenue that permits the incumbent LEC to cover its costs of providing service to low-volume users." Paragraph 9 continues by stating that "[c]ompetition also allows entrants to arbitrage between different pricing systems." Later in the NPRM, paragraph 171 states that "[w]hen element prices have been deaveraged to reflect cost differences, any divergence between element prices and access charges required by regulation creates an artificial incentive to substitute unbundled elements for access." Clearly, arbitrage opportunities represent a tremendous competitive threat to incumbent LEC access revenues.

E. ACCESS PRICES SHOULD BE APPLIED TO UNBUNDLED ELEMENTS.

It has also been stated by the Commission in the Access Charge Docket that costs should be assigned to the interstate jurisdiction and recovered through interstate charges.⁷³ Even in cases, such as Customer Premise Equipment (CPE) and Inside Wire (IW) (where the full costs were generally recovered in the state jurisdiction) the Commission recognized that the booked costs of

⁷³CC Docket No. 78-72; Second Supplemental Notice of Inquiry and Proposed Rulemaking; Released April 16, 1980; ¶ 13.

loops, CPE and IW allocated to the interstate jurisdiction must still be recovered through interstate charges.⁷⁴

The access charge system established in CC Docket No. 78-72 established a nondiscriminatory recovery of the costs actually booked and assigned to interstate by the Commission's accounting and separations rules. The federal allocation of these legitimate, used and useful booked costs recognized by past Commission orders must be fairly recovered in a federal rate structure which:⁷⁵

- Prohibits unreasonable discrimination in that recovery.
- Prohibits undue preference in that recovery.

If the Commission's proposed interconnection plan is allowed to stand, purchasers of interstate access will pay approximately \$.023415 per minute for use for the same facilities for which purchasers of unbundled elements pay \$.005622 per minute.⁷⁶ The result is that if current purchasers move to the lower unbundled rates, approximately \$683 million of SWBT switched access cost recovery and \$705 million of EUCL loop cost recovery assigned to interstate by SWBT through the application of the FCC Part 36 rules, will not be recovered based on SWBT's 1996 switched access demand levels. To remedy this unlawful situation, the Commission must require the application of the full SLC to all purchasers of unbundled loops.⁷⁷ In the event the Commission requires purchasers of unbundled loops to pay only SLCs at capped levels, the flat-rated common line public policy element must also apply. This action will re-establish the neutral

⁷⁴Id., ¶ 53.

⁷⁵CC Docket No. 78-72, Phase 1; Third Report and Order, Released February 28, 1983; Paragraphs 47 to 49.

⁷⁶Based on proxy rates established for SWBT in the FCC's Interconnection Order and SWBT's 1996 rates and demand (Appendix 1).

⁷⁷As the Commission stated in its Order released May 7, 1985, "In the Matter of Iowa Telephone Association Petition For Declaratory Ruling" (FCC 85-228), "any costs of service assigned to the interstate jurisdiction as a result of the separations process should be recovered through interstate charges on the services and customers that cause the costs to be incurred." As the Commission noted further, this principle was upheld by the Court in NARUC v. FCC.

recovery of costs assigned to interstate, between competitively equivalent services for the use of similar facilities to complete calls. This will also eliminate the undue advantage to competitors providing service via unbundled elements, versus competitors providing service via access charges over the same or a similar facility.

In the same way that SLC charges should apply regardless of the purchaser, the costs allocated to interstate and transport, including the TIC, should be recovered from all purchasers of transport elements.

F. THE OPPORTUNITY TO RECOVER ACTUAL INTERSTATE BOOKED COSTS IS PROTECTED BY LEGAL PRECEDENT.

Under federal constitutional and case law, regulators must address the problem of recovery of actual stranded costs before the growth of competition in the industry makes it more difficult to address that problem. In addressing similar cost recovery issues in the gas and electric industries, federal and state regulators have acted in creative ways that promote competition while permitting actual historical cost recovery, thereby avoiding violation of the constitutional prohibition on confiscation.⁷⁸ Indeed, the Commission has previously acted to allow competition in other portions of the telecommunications industry without creating a confiscatory situation.

In the gas and electric industries, as in the telecommunications industry, customers for whose benefit costs were incurred under traditional regulation, may leave the incumbent provider to take service from alternative providers. Since, in a competitive market, prices will not necessarily be based on actual historical costs, as they are under traditional “cost of service” regulation, those prices may not recover the actual historical costs of the incumbent provider’s facilities. In the gas and electric industries, a number of federal court cases stand for the

⁷⁸U.S. Constitution, Amendment V, providing that “private property [shall not] be taken for public use, without just compensation.”

proposition that when actual costs incurred by a regulated utility are stranded by regulatory action, the regulatory agency must provide the utility with reasonable methods and opportunities to recover such actual costs from customers on whose behalf they were incurred.⁷⁹

When the regulated natural gas pipeline industry was opened to competition, many pipeline companies incurred large liabilities in “take-or-pay” costs during the years of the energy crisis. The Federal Energy Regulatory (FERC) ultimately allowed the pipeline companies to recover these costs from customers by way of demand surcharges.⁸⁰ State regulators have also been actively involved in addressing, and trying to prevent or mitigate, potential stranded costs in the natural gas industries.⁸¹

In the electric industry, the FERC has also recognized that open access will cause the “stranding” of actual costs (as well as of under-depreciated assets) of electric utilities that were incurred under traditional regulation.⁸² The FERC has recognized both the legitimacy of utility investors’ right to recover stranded actual costs and the policy necessity of providing for such recovery in order to achieve a fully competitive market. The FERC Order No. 888 carefully provides for the full recovery by electric utilities of stranded actual costs from wholesale customers that choose to change suppliers. A number of states have also addressed the issue of potential stranded electricity costs by authorizing an acceleration of depreciation of nuclear generating assets and other potential stranded costs.

⁷⁹Associated Gas Distribs. v. FERC, 893 F.2d 349 (D.C. Cir. 1984), cert. denied, 111 S. Ct. 277 (1990). See also KN Energy Inc. v. FERC, 968 F.2d 1295, 1301-02 (D.C. Cir. 1992); American Gas Ass’n. v. FERC, 912 F. 2d 1496 (D.C. Cir. 1990); United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996).

⁸⁰See United Distribution Companies v. FERC, 88 F.3d 1105, 1177.

⁸¹See, e.g., State ex rel. Midwest Gas User’s Association v. Public Service Commission of Missouri, Case No. CV 195-1318 cc (Cole County Cir. Ct., 1996).

⁸²Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, Final Rule, FERC Stats. and Regs. Para. 31, 036 et seq. (1996) at 451-455.

In the telecommunications industry itself, the Commission has previously successfully promoted the introduction of competition without relying on confiscatory methods. For example, when competition was brought to long distance services, the Commission did not require AT&T, then the dominant provider of long distance services, to subsidize the development of competing long distance services. While the Commission required AT&T to resell its services to its competitors, it did not require them to do so on a forward looking incremental cost basis such as TELRIC.

Additionally, in deregulating CPE in the early 1980s, the Commission removed embedded CPE from the federal-state separations process by reducing the booked amounts of CPE and related expense accounts over a five-year period.⁸³ The Commission used a similar amortization process for inside wiring.⁸⁴ In neither case did the Commission ignore the existence of the embedded costs.

Thus, based upon the precedents in the gas and electric industries, as well as in the Commission's previous introduction of competition into the long distance, CPE, and inside wire markets, the Commission should not use extraordinary means, i.e., TELRIC pricing, to introduce competition into the local exchange market, without a corresponding method to allow incumbent providers to recover their actual historical investment.

⁸³See Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, Decision and Order, 89 FCC 2d 1, modified, 90 FCC 2d 52 (1982).

⁸⁴See Amendment of Part 31, 85 FCC 2d 818, 828-829 (1981).

VI. LONG DISTANCE PRICES MUST BE REDUCED TO REFLECT THE EFFECT OF LOWER ACCESS PRICES.⁸⁵

A. IXCS WILL PAY LOWER ACCESS CHARGES UNDER SWBT'S PLAN.⁸⁶

SWBT's plan to increase the SLC and to establish an end user port charge would generate annual carrier access charge reductions of approximately \$197M. Access charges will be further reduced by approximately \$81M for the effect of the changes to the recovery mechanisms for pay telephone and LTS. This represents true expense savings to IXCs.

B. CUSTOMERS MUST RECEIVE THE BENEFITS OF EFFICIENT ACCESS PRICES.

The Commission has a longstanding goal of promoting customer benefits through lower charges, particularly long distance prices. While competition in the long distance market was intended to produce lower prices, the Commission has also relied heavily on access price reductions, especially those related to SLC increases, to achieve its goal. An additional benefit of lower long distance prices is associated with the demand stimulation effect accruing to customers from even lower prices. Lower prices represent a better value; consequently demand increases. SWBT's plan is designed to create these customer benefits with cost causative rate structures and efficient prices that are no longer used to recover public policy costs.

C. IXCS MUST BE REQUIRED AS A MATTER OF PUBLIC POLICY TO REDUCE LONG DISTANCE PRICES.

IXCs maintain that access charges represent almost half of the costs they incur to provide long distance service. Today's long distance prices should be reduced by an amount equal to the implicit support that will be removed from ILEC access prices. The Commission should follow the precedent it established when it required IXCs to reduce their long distance prices after

⁸⁵This section addresses NPRM Section I.B.

⁸⁶This section addresses NPRM Section I.B.

previous SLC increases. To do otherwise would permit IXC's to realize unreasonable profits without having made improvements in their efficiency. The public policy implication of this step cannot not be overstated if customers are to realize the full benefits of the Telecommunications Act.

VII. CAPITAL RECOVERY ISSUES MUST BE ADDRESSED⁸⁷

A. DEPRECIATION RESERVE DEFICIENCY AMORTIZATION⁸⁸

In the NPRM, the Commission recognized the possibility of an "under-depreciation of incumbent LEC assets."⁸⁹ Under-depreciation is more than a possibility; it is a fact.⁹⁰

Under rate of return regulation, increases in depreciation rates increased the regulated cost of service and translated directly into price increases. Regulators therefore had the incentive to keep depreciation rate increases as small as possible. Regulators generally reasoned that they needed to avoid "rate shock," described as a sudden increase in prices, or to keep prices low to achieve universal service and other regulatory objectives. In monopoly rate of return regulation, under-depreciation appeared justifiable because regulators could guarantee that incumbent LECs would eventually recover their capital and that the LECs would earn a fair rate of return on that capital until it was recovered. The effect of these decisions was to push the increase in revenue requirements associated with under-depreciation into future time periods for future customers.

This type of untimely recovery can no longer be assured. In a competitive environment, capital recovery cannot be extended past the economic life of technology. Customers who have

⁸⁷This section addresses NPRM Section VII. B.

⁸⁸This section addresses NPRM Section VII. B.

⁸⁹NPRM, ¶ 250.

⁹⁰A detailed economic analysis of the depreciation catch-up issue is presented in Appendix 2.

competitive alternatives will demand the service functionalities provided by the latest technology. If the incumbent LECs cannot provide improvements inherent in new technologies as soon as they are available, then the customers, along with the revenues to recover depreciation expense, will move to competitors that can and do provide the new technologies.

The NPRM states that "facilities may be under-depreciated if the useful lives prescribed for regulated facilities exceed the economic lives of those facilities."⁹¹ In fact, the word "may" in this quote should be replaced with "would", because it is inconceivable in this case that under-depreciation would not occur. "This under-depreciation often occurs when new technologies are introduced that reduce the remaining economic lives of embedded plant."⁹² New technology does reduce the economic lives of embedded plant, causing the economic obsolescence of older technologies. Digital electronic switching systems ("ESS") reduced the economic lives of electromechanical switching and analog ESS. Fiber optic cable reduced the economic lives of copper cable. Competition in telecommunications markets accelerates the introduction and adoption of new technologies and the economic obsolescence of the older technologies.

The problem of recovering capital under such reduced lives has been exacerbated by the procedural demand of regulators for "proof" that the new technology really has explicitly reduced the expected remaining life of the old technology. The primary proof expected by regulators is actual physical retirement and planned retirement information focused on the old technology. The regulatory realization of the shortened economic lives is thus incorrectly postponed from the introduction of the new technology to the end of the physical lives of the old technology.

⁹¹ NPRM, ¶ 251 (emphasis added).

⁹²NPRM, ¶ 251.

SWBT has quantified the interstate depreciation catch-up amount as \$463 million. Support for that calculation and a description of the method is contained in Appendix 2.

B. RECOVERY OF DEPRECIATION CATCH-UP AMOUNTS.

SWBT proposes that recovery of the depreciation catch-up amount be from a separate public policy element established specifically for that purpose. The total dollar amount obtained from the depreciation catch-up element would be held constant for each of five years, during which the five-year amortization would be fully recovered. The total interstate amortization is \$463 million; the annual amount is \$93 million. The annual amount should be charged to IXC's who received the benefits of the prior lower access prices. SWBT proposes to apportion the \$93 million in amortization among IXC's based on their average historical share of interstate access charges paid to SWBT over the past three years. This would keep the responsibility for past under-depreciation associated with past purchases from SWBT and separate from any prices paid by new market entrants.

VIII. SWBT'S RESPONSES TO OTHER ISSUES RAISED IN THE NPRM.⁹³

A. PRICE CAP ISSUES

Effects on Achieved Productivity of Alternative Common Line Rate Design

If the Commission decides to alter, prescribe, or permit a change in the recovery of NTS costs previously charged on a per-minute basis (i.e., the CCL), then there are predictable effects on the achieved results of the LECs. If the CCL were assessed on a per-line basis rather than on a per-minute basis as is currently the case, this would represent a drain on the ability of the price

⁹³This section addresses NPRM Sections III.D.; VI.C.; VIII.C.

cap LECs to generate productivity. As CCL recovery is removed from a per-minute charge, the existing more restrictive Common Line PCI formula should either: (1) be revised so that the CL PCI uses the same PCI formula as the other baskets, without the "g/2" components; or (2) if the decision is to not subject Common Line to price cap regulation, be removed entirely.

The productivity potential of the price cap LECs will be reduced by the extent to which the demand base on which NTS cost recovery is assessed grows more slowly than CCL minutes of use. For example, for the Price Cap LECs, over the 1991-95 time period, CCL minutes of use grew at an average annual rate of 6.8%, while access lines grew at an average of 3.0% annually.⁹⁴ The effect of assessing CCL on a per-line basis thus has the potential, all else equal, of reducing interstate revenue growth by about 0.5% per year.⁹⁵ The basic result is inescapable, as the recovery mechanism is shifted off of a more-rapidly growing demand base to a more-slowly growing, flat or declining demand base, the productivity potential of the price cap LECs is significantly reduced.

Effects on Productivity of TIC and Other Rate Design Changes

The same basic effect applies to the TIC and other rate elements as well. As the Commission permits or requires that these other rate elements be shifted from per-minute to flat-rated, bulk-billed or other bases, the productivity potential of the price cap LECs is concomitantly reduced. As a result, the estimates of productivity forthcoming from historical studies will overestimate the productivity potential of the LECs in a post-access reform environment.

⁹⁴The source for this data is the Christensen TFP Study for the Price Cap LECs, filed by USTA in CC Docket No. 94-1, Fourth Further Notice, Attachment B.

⁹⁵Calculated as (6.8% minus 3.0% equals 3.8%) times (the share of interstate revenue represented by CCL, approximately 14%) yields a result of approximately 0.5% revenue growth per year. This result is consistent with the estimates of 0.7% and 0.8% made by AT&T, MCI and Sprint on the record in CC Docket No. 94-1 that use older slightly higher minutes growth.

Rules for Revising PCIs When Services are Removed from Price Caps or Transferred Among Baskets

The NPRM asks in three separate places what the appropriate price cap mechanics should be when revenues/services are removed/transferred from price caps or price cap baskets.⁹⁶ While the existing exogenous cost adjustment mechanism has been used to remove revenue from price caps, it is not appropriate, without modification, for use with baskets of services having more than one layer of price cap constraint (ie: service categories or sub-categories). An exogenous cost based PCI reduction like that used to remove payphone set cost recovery from the Common Line basket is the proper methodology to be used to remove revenue from price cap baskets having no service categories or sub-categories.⁹⁷

To remove revenue from a basket or transfer revenue between baskets that contain service categories or sub-categories, PCIs, APIs, SBIs and SBI band limits for the affected baskets, categories and sub-categories should be adjusted to reflect the removal/transfer of the proper amount of capped and actual revenue.⁹⁸ This methodology will result in the same removal/transfer of capped and actual revenue as not adjusting the indicies as long as an SBI upper limit is not acting as a revenue cap on an affected category.

⁹⁶NPRM, ¶ 122 (TIC revenue reallocations), ¶ 154 (services removed from price caps), and ¶ 245 (universal service support revenue adjustments).

⁹⁷In the case of payphones, revenue was removed from price caps. It also required an intra-basket restructure to transfer the recovery of payphone line costs from the CCL to the SLC.

⁹⁸The PCI(s) for the affected basket(s) should be adjusted based on the relationship between the capped revenue being removed and the basket capped revenue. Capped revenue for a category (or portion of a category) is the lesser of the revenue allowed by the SBI upper limit or the revenue calculated by multiplying the ratio of basket capped revenue to basket actual revenue by the actual category revenue. The API(s) and SBI(s) for the affected basket(s) and category(ies) should be adjusted based on the relationship between the actual revenue being removed and the basket/category revenue. The SBI(s) upper limit(s) should be adjusted based on the relationship between the adjusted SBI(s) and the current SBI(s). (SBI lower limits have been eliminated in the companion Third Report and Order) SBIs and SBI upper limits for categories not affected by the revenue removal or transfer need not be adjusted.

B. EQUAL ACCESS AND NETWORK RECONFIGURATION COSTS

In paragraph 293 of the NPRM, the Commission invited comment on whether an exogenous cost decrease should be required to account for the completion of the amortization of equal access network reconfiguration costs. The Commission recognized that there is a basic fairness issue involved in as much as it has already disallowed exogenous cost treatment of any additional costs incurred subsequent to the implementation of price cap regulation.

This issue has been asked and answered. The Commission has declined to mandate exogenous cost treatment for this expiration. No convincing new arguments have surfaced that warrant the resurrection of this issue. As SWBT noted in its 1994 Annual Filing Reply Comments (Page 2), the exogenous costs established by the Commission and included in its 61.45(d) rule include other amortization completions such as RDA and inside wire, but specifically omit the equal access network reconfiguration amortization. All parties, including the Commission, were well aware of the existence of this amortization during the price cap rule formulation period. The Commission had good reason for rejecting exogenous cost treatment. In the LEC Price Cap Order on Reconsideration (fn. 77), the Commission stated,

We also declined to adopt MCI's suggestion to treat BOC equal access costs in the same way we do amortizations, and require a downward adjustment in PCI levels in 1994 to eliminate all equal access costs. MCI argues that January 1, 1994, is the date when AT&T is required to reimburse the BOCs for any unrecovered equal access costs, and that the BOCs will have fully recovered their costs at that time. . . . The issue to be addressed is whether the BOCs will experience any cost change in 1994 that stems from factors beyond their control. Under price cap regulation, we have not treated changes in depreciation levels as exogenous This is consistent with our view that the price cap index should be devoid of cost indicators over which the carriers exercise control. Based on the meager factual record presented on the issue of equal access costs, we are reluctant to depart from our practice of not adjusting PCI levels to reflect levels of cost recovery.

This reasoning is as valid today as it was in 1994. No factual record supporting exogenous cost treatment has been presented. Further, SWBT has incurred additional equal access expenditures since price cap implementation that have not been granted exogenous cost treatment. SWB continues to incur depreciation expense associated with equal access investments that were not fully depreciated as of the amortization completion date since it was required that these investments be depreciated over their normal lives rather than the amortization period. The Commission should move on in its reform efforts and refuse to continually revisit this issue.

C. CHANNEL FACILITY ASSIGNMENT CONTROL SHOULD NOT BE THE SOLE CRITERION FOR A TRANSPORT STRUCTURE.

The Commission requested comments (§ 86) on whether the incumbent LECs should be permitted to offer transport services differentiated by whether the LEC or the IXC is responsible for channel facility assignments ("CFA"). Should the Commission follow SWBT's recommendation to eliminate the MOU switched transport option between the SWC and the tandem, CFA could be a mechanism to determine if transport is dedicated or shared. However, CFA responsibilities may vary between LECs. Additionally, a transport structure based on CFA control may become untenable with the deployment of ATM switching combined with SONET transport. These types of technologies allow many services to be provided over a single (e.g. OC3) channel due to the bursty transmission characteristics of cell technology. Consequently, SWBT does not feel that CFA control should be the basis of a transport structure because it may be administered differently between LECs and may well become obsolete as newer technologies permeate our network.

D. PEAK/OFF-PEAK PRICING SHOULD NOT BE MANDATED.

The Commission requested comments (§ 90) on whether to permit or require incumbent LECs to develop peak and off-peak pricing for tandem switching). LECs should be permitted the flexibility of peak and off-peak pricing. However, the Commission is correct in its conclusion that there might be practical problems with a rate structure that had peak and off-peak pricing. In the Interconnection Order (756), the Commission identified that “different parts of a given providers’ network may experience peak traffic volumes at different times” and that “peak periods may change over time.” For these very reasons, SWBT does not feel that peak/off-peak pricing is the appropriate pricing structure.

E. DIRECT TRUNKED TRANSPORT CUSTOMERS ALREADY PAY FOR THEIR USE OF THE TANDEM SWITCH.

The Commission invited comments (§ 90) regarding recovery of tandem switching costs from direct-trunked transport service customers. Tandem switching costs are currently appropriately recovered from tandem switch users, including direct-trunk transport customers via tandem switching MOU rates. It is not appropriate to levy any additional service specific charge to direct-trunk transport customers for switch usage they may never incur. The imposition of a service specific charge would drive large IXC’s to seek alternate transport providers to avoid this charge while increasing the rates of smaller IXC’s. SWBT’s access reform plan does acknowledge that the Commission could elect that some portion of tandem switching costs be recovered from access customers via a competitive neutral public policy element.

F. COMMON SWITCHED TRANSPORT IS ONLY BETWEEN THE TANDEM AND THE END OFFICE.

The Commission seeks comments (§ 91) on appropriateness of measuring tandem switched transport from the SWC to end office or in two charges, one for the SWC-to-tandem circuit and one for the tandem-to-end office circuit. As the Commission has previously acknowledged and SWBT's access reform plan has indicated, the circuit between the SWC-to-tandem is dedicated and should be recovered with flat rated charges. In the alternative, a two charge approach is representative of the physical path used to complete tandem traffic if the Commission elects to maintain an MOU option between the SWC-to-tandem.

IX. CONCLUSION

In this docket, the Commission has the opportunity to adopt an access charge plan that will provide a timely, efficient, and flexible transition to competitive access pricing. It is imperative that the Commission "get it right." Out-dated regulation cannot produce the "pro-competitive and deregulatory" environment envisioned in the 1996 Act. The Commission must use this docket to establish a plan for access reform that is based on cost causative principles and that affords incumbent LECs a reasonable opportunity to recover their actual costs.

As shown in these Comments, the approaches proposed in the NPRM neither recognize the urgency of access reform nor provide incumbent LECs with sufficient flexibility to compete with telecommunications services providers that can offer their own access services using directly substitutable unbundled network elements at prices based on forward-looking cost. The "market-based" approach prevents ILECs from utilizing the same pricing flexibilities that rebundlers possess until they meet the untenable burden of a service-by-service, market-by-market competitive demonstration, thus unnecessarily perpetuating regulatory hurdles. Likewise, the

“prescriptive” approach to access reform as described in the NPRM substitutes heavy-handed, ongoing regulation for the competitive forces of the marketplace. Neither approach represents access *reform*.

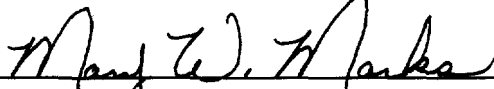
On the other hand, SWBT’s plan as detailed in these Comments provides an appropriate and efficient approach to access reform that fulfills the Commission’s goals as well as the mandates of the 1996 Act. SWBT’s approach combines initial prescriptive-oriented price rebalancing with subsequent customer-responsive pricing flexibility. SWBT’s plan not only provides for fair competition in the provision of interstate access services but also provides flexibility and fair compensation for the ILECs. The two steps of SWBT’s plan establish efficient access prices by addressing public policy cost recovery issues and provide for a competitive access pricing structure.

As the Commission pointed out in the NPRM, the need for access reform is almost universally acknowledged. The issues are clear and readily addressable. The only choice for the Commission is to adopt a plan that represents true reform rather than falling back on regulatory

“solutions” that have no place in the new world of unbundled network elements. Adoption of SWBT’s plan for access reform would be a critical first step toward a fully competitive market for exchange access.

Respectfully submitted,

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Analyses Supporting SWBT's Access Reform Recommendations

I. Introduction

This appendix presents analyses supporting SWBT's recommended plan for modifying interstate access charges. It provides cost support, where necessary, for the proposed modifications. SWBT's plan proposes changes to existing interstate access rates for Common Line, Local Switching and Transport to allow them to be appropriate for the competitive market place while still allowing LECs sufficient cost recovery to support and maintain high quality networks and services.

II. SWBT's Interstate Access Rates Reflect the Recovery of Legitimate Costs Booked to Part 32 Accounts and Allocated to Interstate Access Services by Parts 36 and 69

The initial basis for price cap LEC's interstate access rates were the Commission's Part 32 accounting, Part 36 jurisdictional separations, and Part 69 access charges allocation rules. Prior to price caps, LECs developed interstate access costs, by element, pursuant to the Part 36 and Part 69 rules. These rules continue to serve as the basis for rate of return LECs' interstate access rates. Additionally, these rules are used to identify costs for measuring LECs' interstate earnings and the cost basis for the sharing and the low-end adjustments established by the Commission. Under these rules, investments, reserves, expenses, and taxes are assigned or allocated to interstate access elements. In general, costs (investments, expense, taxes and reserves) are first booked into the Part 32 accounts. Part 36 then assigns these amounts to categories which are then allocated to the interstate and intrastate jurisdictions. Under Part 36 Rules, costs are first categorized by function (i.e. loop, trunk, switching, etc.). Next the costs are generally allocated through a four step process: (1) direct investments (central office equipment and cable and wire facilities) are allocated based on a relative use measurement (switching minutes-of-use (MOU), trunk usage, etc.); (2) facility-related expenses (i.e., maintenance, depreciation, etc.) are allocated based on the allocation of the direct facility investments; (3) service expenses are allocated based on studies of work functions; and (4) network and service support and common costs (i.e. general support investments, corporate expenses, etc.) are generally allocated based on groupings of allocated direct investments or expenses.

The costs assigned to interstate services by Part 36 and 69 rules represent legitimate costs incurred by SWBT to provide services. These cost assignments and allocations are closely scrutinized by the Commission and access customers. Price cap LECs' cost calculations were subject to stringent criteria when they were under rate-of-return regulation, including the use of statistical criteria for evaluation of cost levels. The Commission approved rates based upon these costs as the initial price cap rates that were effective beginning January 1, 1991. Consequently, these costs represented the legitimate costs of providing telecommunications service that were assigned to interstate access services for recovery.